April 25, 2016

Spring Quarterly Commentary

"If you want to be entertained, take up sky diving. There is an inverse correlation between an investment's entertainment value and its expected return."

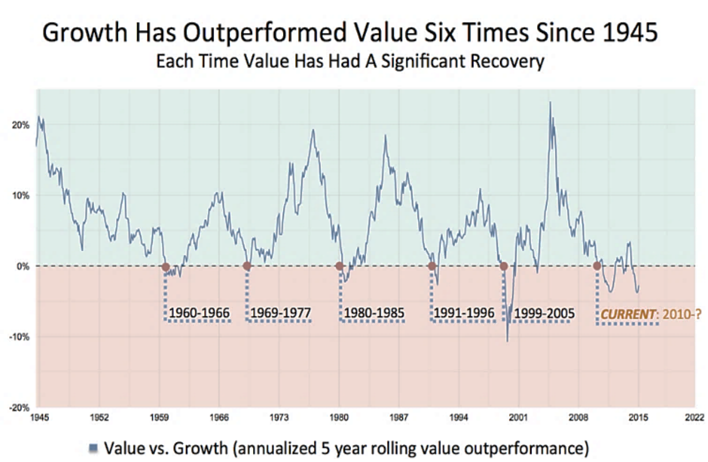
William J. Bernstein, PhD (born 1948)
Neurologist
American Financial Theorist & Author

The first quarter of 2016 witnessed a frightening pullback until mid-February when a more interesting phenomenon, what some commentators have taken to calling "the great pain trade of 2016", took hold. This "pain trade" crushed a number of funds that had crowded into last year's high flying stocks (they had also piled into short positions on plummeting stocks). What had been "working" (popular stocks going up, unpopular stocks going down) all of a sudden stopped "working", and in many cases sharply reversed. Some of the most popular areas of investment, such as the so-called FANG[1] stocks, biotechnology, and hedge-fund-guru-stocks such as Valeant (down 67% year to date) and SunEdison (now in bankruptcy) all underperformed. Meanwhile, less popular and more heavily-shorted areas like basic materials and value stocks, which heretofore had obediently declined in price, instead sprang to life, turning on their former hedge fund masters with aggressive price increases. Indeed, much of this action appears directly related to a stock's popularity with hedge funds, who, being a relatively short-term oriented crowd, tend to exit positions that aren't "working", thereby exacerbating adverse price moves. It must

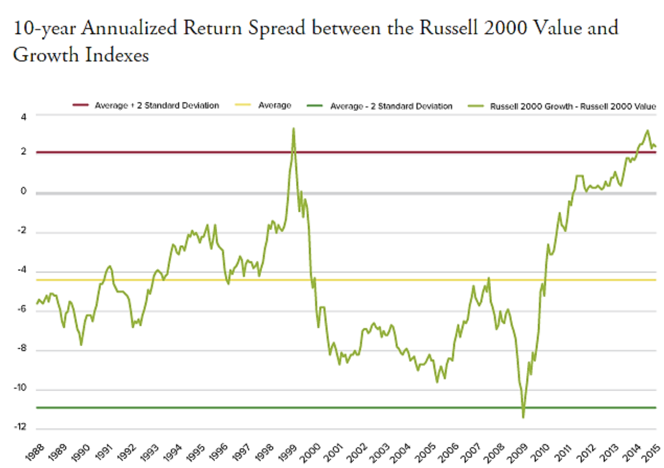
[1] FANG stands for Facebook, Amazon, Netflix and Google, all information technology stocks that were among the largest and best performers of 2015. Their collective P/E ratio is still above 50, more than twice the market's.

have been entertaining watching these names go up and up... until they didn't. Fortunately, we actively seek to avoid entertaining stocks. Also, as a result of many of our stocks being painfully out of favor for some time, the recent "pain trade" has been largely beneficial for our portfolio. Indeed, around here it has been jokingly called "the great pleasure trade of 2016".

To the extent that the "pain trade" represents the unwinding of crowded positions held by short-term oriented investors, it would not be expected to last very long. However, we do wonder if a larger turning point is afoot. Two of the most consistent outperforming investment factors studied by academics and used by quants are momentum and value[2]. In recent years, before the aforementioned reversal, momentum stocks had been doing fantastically while value stocks had been in a prolonged slump. In fact, value stocks have been in by far their most drawn out period of underperformance versus growth stocks since World War II. As the following charts indicate, any prolonged underperformance by value stocks has historically given way to sharp outperformance. Knightsbridge and our contrarian value-seeking strategy experienced this firsthand during the 1990's when three years of underperformance was more than made up in a single year when momentum stopped working and value stocks kicked into gear. The chart also shows that value stocks consistently outperformed in almost every five-year period during the 20th century; despite the recent unprecedented slump, we expect the current century should be no different. After all, shouldn't it be more financially rewarding to buy companies which are cheap relative to their operating results? We look forward to offering proof.



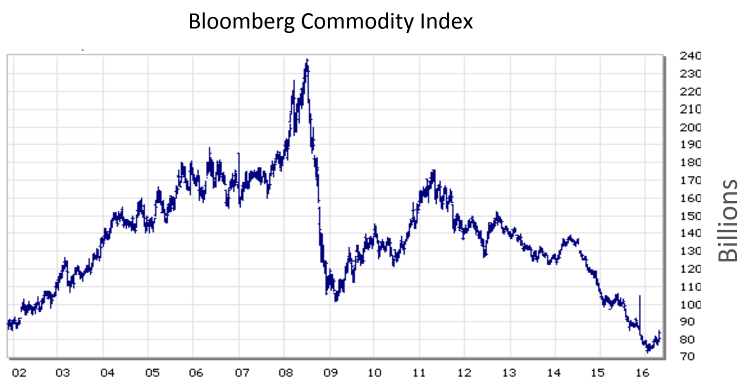
Source: Fund Evaluation Group / Euclidian Technologies



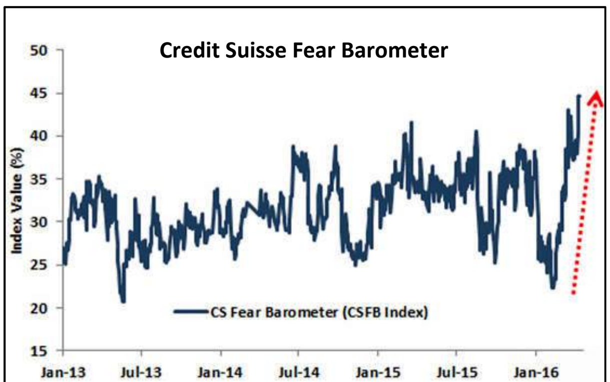
Data courtesy of Furey Research Partners

[2] "Quants" are funds that base their investment decisions on computer-driven quantitative analysis. "Momentum" typically means the rate of advance in a stock price over the prior year. "Value" typically means the ratio of a stock fundamental (usually earnings or book value) relative to its price.

To cite one trend that has reversed, the multi-year commodity rout has recently been interrupted with a small rally which, if sustained, has the potential to represent the beginnings of a multi-year turnaround. We have built a position in BCX, a natural resource closed end fund which offers a more than 15% discount to NAV (we expect this discount to narrow over time[3]). This means we bought a basket of high-quality companies (such as Exxon Mobil, Monsanto, and Alcoa) for prices 15% below what their individual (already depressed) prices were at the time. This investment sports a hefty payout, currently 10%, but make no mistake, this isn't a real dividend representing sustainable earnings by the underlying enterprises. Rather, the payout is largely a return of the fund's underlying capital... which is fine with us because we know each $1.00 of value paid out was purchased for $0.85 or less[4]. We are also on the verge of adding a well-positioned energy stock to the portfolio. As always, we invest opportunistically in those areas which have fallen out of favor when we believe conditions may improve over coming years.



Source: Market Watch



Source: Credit Suisse

What are conditions generally? One readily apparent condition in the market is fear and mistrust of the recent rally. To cite but one example, the recently released Credit Suisse Fear Barometer, which uses option prices to

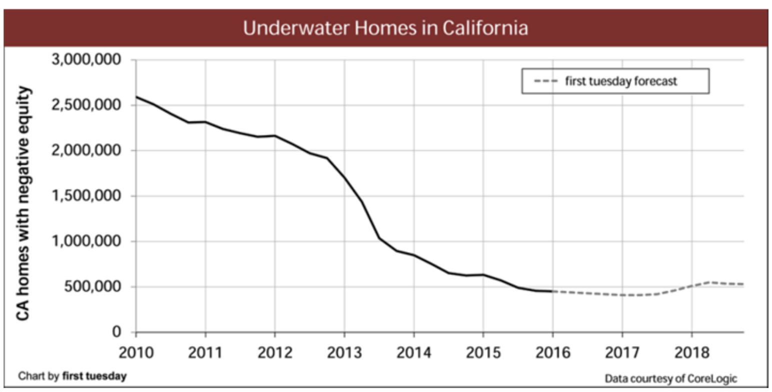
[3] To be fair, we began slowly building this position back in June of last year, thereby committing our perennial sin of "being early". In our defense, aside from the unrealistic possibility of buying a stock at its absolute bottom, being early is a necessary sin that must be committed in pursuit of avoiding the greater sin of chasing performance.

[4] This high payout and return of capital also ensures that the printed price of the fund that appears on brokerage statements will have a strong bias to go down. The gain/loss value that appears on a brokerage statement doesn't take the dividend into account and therefore will show a result meaningfully lower than the dividend-inclusive performance actually experienced by the owner.

determine the level of fear in the market, has reached heights not seen in years. Characteristically, the market has continued to advance since this data showing pessimism was released.

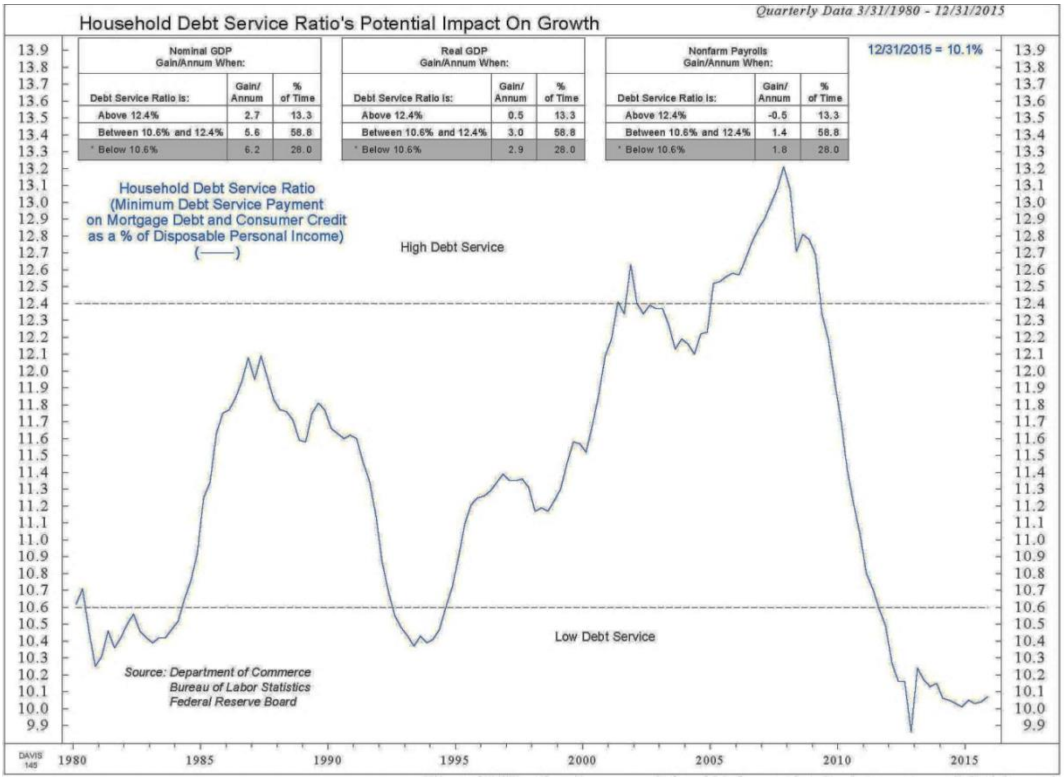
There are indeed some very good reasons to be fearful. The current U.S. economic expansion and equity bull market are both certainly long in the tooth. Equity valuations in relation to reported earnings remain above average. However, we see important reasons why both the economic expansion and market strength may continue.

In terms of the economy, while it is true that this expansion has run long enough that by now one might typically expect a recession, it is also true that it has been a much shallower than typical expansion, with muted GDP growth, muted job growth and almost nonexistent inflationary pressures. This, along with the observation that the most recent recession was more severe than typical, argues that the current economic expansion may yet have legs.



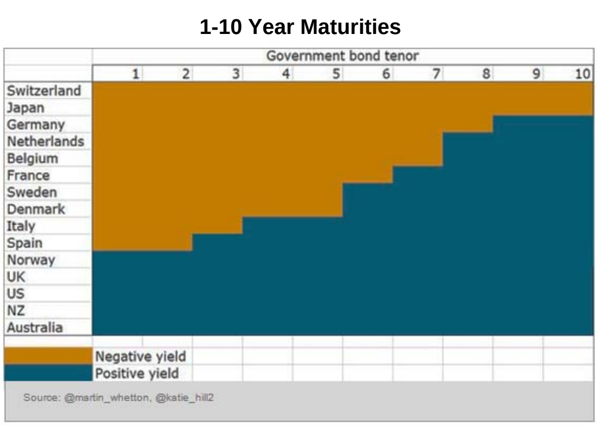
The housing cycle may also prove to be a driver of the greater economic cycle. Construction and pricing have been on the upswing. The housing rebound has more implications than just more construction jobs: with time and price appreciation, fewer and fewer homes are underwater relative to mortgage values. An underwater mortgage often prevents a family from moving. When this situation reverses, the freedom that ensues means families can move into that bigger house or can move to a different area for that better job... driving the housing cycle, and in turn the economy higher.

Further economic fuel comes from the steep decline in overall household debt service relative to disposable income. Though most of the heavy lifting in the improvement of this ratio came from lowered interest rates, in general Americans have paid down debt instead of spending. While this has actually been one of the causes of the slow recovery from the financial crisis, it now puts us on a better footing for the future. The following chart shows that GDP and payrolls have increased at a faster rate historically when at a lower debt service ratio (we currently reside in the shaded zone of the three boxes on the chart).



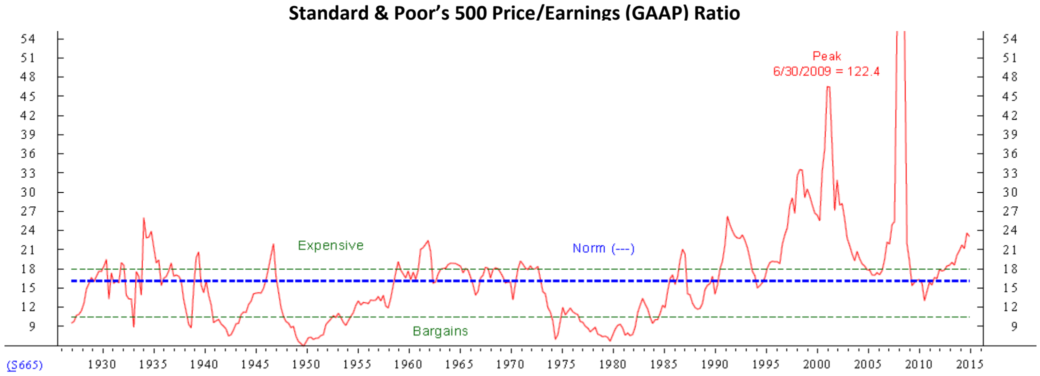
Source: Ned Davis Research

This brings us back to the stock market. A growing economy and historically low interest rates could keep an expensive stock market going. But wait you say, the Fed is raising rates! Yes, it did (one quarter of a percentage point) and it will probably try again... but these attempts will likely be beaten back by worldwide economic tremors when they do. We continue to be in the "rates will be lower for longer" camp until proven otherwise. While U.S. interest rates seem appallingly low to those looking in the rearview mirror, to a person looking around they are some of the highest in the developed world (many of these countries have negative rates). This dichotomy makes it extremely difficult for U.S. rates to rise without causing the economic turbulence that would prompt policymakers to lower them back down again[5]. As we have discussed



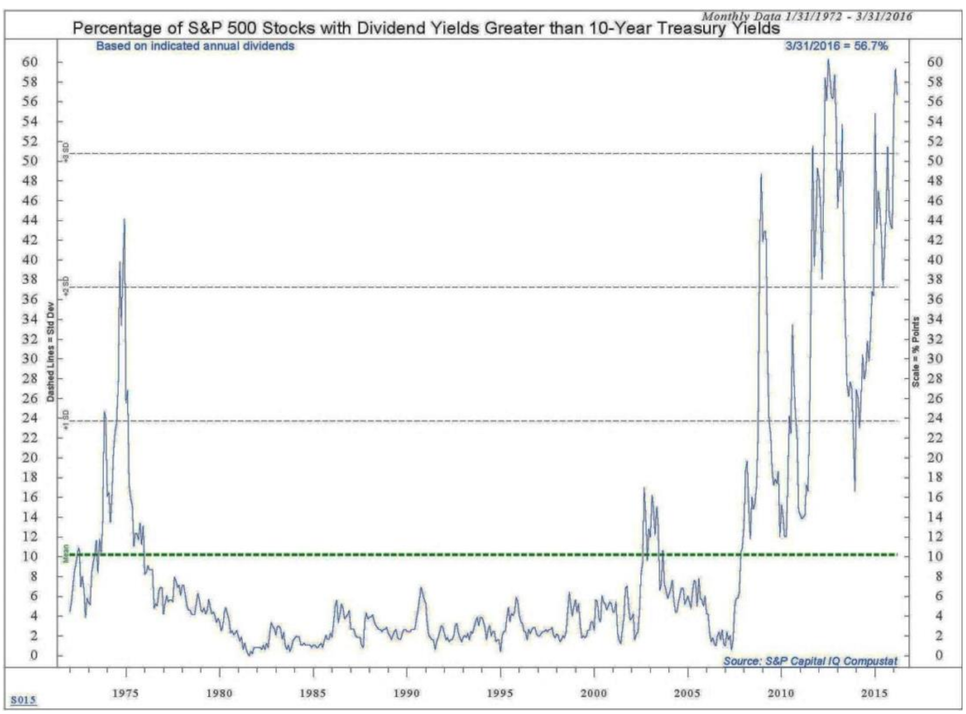
[5] For those who believe central bankers have no room for further easing because rates are near zero, think again. We think more and more serious policymakers will begin discussing the prospect of "helicopter money"... literally giving money directly to the populace. Both current European Central Bank chief Mario Draghi and former Federal Reserve chief Ben Bernanke let these tabooed words escape their mouths recently; we expect this trend to continue.

before, historically low interest rates support historically high valuations, and interest rates do not necessarily mean revert within anything approaching a normal investing timeframe.



Source: Ned Davis Research

One illustration of how low interest rates could further elevate equity prices is the fact that the majority of the S&P 500 Index constituents offer a dividend yield greater than ten-year Treasury yields (see chart). Absent a change in interest rates, a normalization of this uncommon status would require that stocks rise further, thereby diminishing their dividend yield (dividend/price).

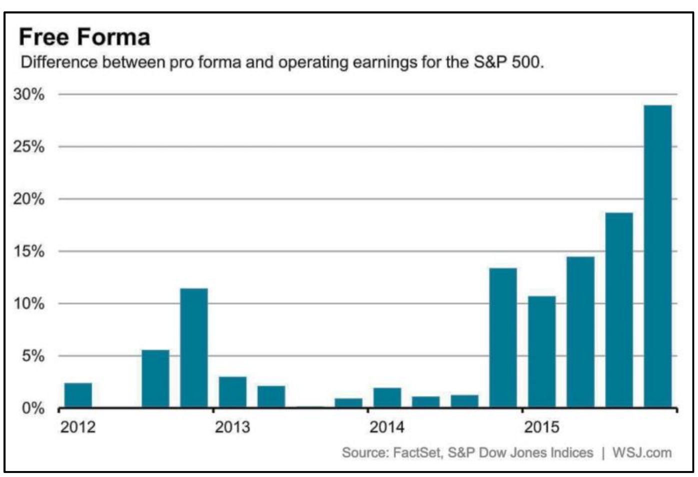


Source: Ned Davis Research

To sum up, we remain cognizant of the increased risk that high stock market valuations and aging economic recoveries bring, but at the same time remind ourselves of the extenuating circumstances that could allow these conditions to prevail instead of reverse.

As an aside, what *would* make us change our minds about low rates and high market valuation? That would be *sustained* wage growth and high inflation. These developments have been long predicted but so far have yet to materialize. When those facts change, we will change our opinions, as well as our portfolios, and prepare for more historic valuation levels. In the meantime, we have begun partial preparations for this eventuality by leaning against stocks that are more reliant on stable financial markets. As always, the best protection comes from not owning the most expensive stocks with the furthest to fall.

To cite one example, consider the relative valuation of Apple. It trades at 12 times trailing GAAP reported earnings. The S&P 500 GAAP P/E is 23 when not ignoring "one time" items such as write-offs (more on this below). Apple furthermore has $216 billion in cash and securities on its balance sheet against only $63 billion in total debt, for a net cash and securities position of $153 billion (or about 25% of current market capitalization). This is truly a fortress balance sheet and compares very favorably to the substantial net debt position many companies today carry. Apple will certainly not grow as much as it used to (indeed earnings are projected to fall this year) but we appreciate the measure of safety inherent in buying strong, cash-rich companies at a 50% discount to the P/E of the S&P 500.



Before we close, we want to mention a troubling trend, which brings with it a whiff of the optimistic myopia that often accompanies market tops. An increasing number of companies are emphasizing "adjusted" or "pro forma" results which are presented alongside those required by GAAP accounting standards. Commonly the adjusted result presented is not even "adjusted earnings" but is rather "adjusted EBITDA" which ignores not only "non-recurring costs" (like dumb acquisitions) but also very important ongoing costs (like physical maintenance). Often a 30 plus page business presentation will only mention actual official GAAP earnings exactly once: in the appendix where the SEC mandates its

appearance. Numerous studies confirm our observation that the practice is increasing. This makes us wary.

When followed, U.S. accounting standards have served investors well for a very long time; in large part they were created to prevent CEOs from showing a slanted and inaccurate scorecard to investors. We believe that how companies present results says a lot about the quality of management and company culture. We are pleased that a recent portfolio addition, Thor Industries, as one example, specifically states in its material, "We report net income, not adjusted earnings to cover up performance." Companies which do not trumpet adjusted results in order to paper over inconvenient charges and expenses increasingly represent an "anomaly"...the sort of thing we like to find. We believe these positions will serve us well in the event of a downturn, when enthusiasm for flimsy non-GAAP numbers typically wanes.

Lastly, you may have heard about the new fiduciary standard rules released by the Department of Labor that require brokers and financial advisors to act in clients' best interests when advising them on retirement funds. It might further have surprised you to learn that this was not previously the case! Since our founding, Knightsbridge has been registered with the Securities and Exchange Commission as a Registered Investment Advisor, which has always required us to uphold a fiduciary duty to serve your best interests. We will always endeavor to do so in every effort. This is why we invest our family money alongside yours, why we report clear bottom-line results to you (good luck finding that on a brokerage statement!), and why we appreciate your trust and value your hard-earned assets being placed under our care.

Sincerely,

John Prichard | Miles E. Yourman

John G. Prichard | **Miles E. Yourman**

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